



**MASSACHUSETTS WATER
POLLUTION ABATEMENT TRUST**

(A Component Unit of the Commonwealth of Massachusetts)

Financial Statements and Required Supplementary Information

June 30, 2003 and 2002

(With Independent Auditors' Report Thereon)

**MASSACHUSETTS WATER
POLLUTION ABATEMENT TRUST**
(A Component Unit of the Commonwealth of Massachusetts)

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Independent Auditors' Report

The Board of Trustees
Massachusetts Water Pollution Abatement Trust:

We have audited the accompanying basic financial statements of the Massachusetts Water Pollution Abatement Trust (the Trust), a component unit of the Commonwealth of Massachusetts as of and for the years ended June 30, 2003 and 2002, as listed in the table of contents. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Trust as of June 30, 2003 and 2002, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 3 through 8 is not a required part of the basic financial statements but is supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.



KPMG LLP, KPMG LLP, a U.S. limited liability partnership, is
a member of KPMG International, a Swiss cooperative.



In accordance with *Government Auditing Standards*, we have also issued a report dated October 30, 2003, on our consideration of the Trust's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

KPMG LLP

October 30, 2003

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Required Supplementary Information
Management's Discussion and Analysis

Management's Discussion and Analysis

The following is management's discussion and analysis of the financial position and activities of the Massachusetts Water Pollution Abatement Trust (the Trust), a component unit of the Commonwealth of Massachusetts, for the fiscal years ended June 30, 2003 and 2002. This discussion is a narrative overview and analysis of our financial activities and should be read in conjunction with the accompanying financial statements.

Financial Highlights – Fiscal 2003

- Assets exceed liabilities by \$1.3 billion, a 5% increase over FY02, at the close of the fiscal year. Included in this number is loans receivable, which increased from \$1.8 billion in FY02 to \$2.1 billion in FY03.
- Net assets increased by \$65 million from last year, a net change of 5%.
- Operating income decreased by \$30.3 million from FY02.
- The statement of cash flows indicates a negative change in cash for the year of \$7.4 million.
- In FY03, the Trust continued to receive its Capitalization Grants from the Environmental Protection Agency in both the Clean Water and Safe Drinking Water programs. The Trust received \$45.0 million for the Clean Water Program and \$28.8 million in the State Drinking Water Program. The Commonwealth provided a match of \$9.1 million for these federally funded programs. This has allowed the Trust to continue to expand the base of capital in the Revolving Fund and support the administrative costs without having to heavily rely on the Commonwealth of Massachusetts to keep the program viable.
- The Trust continues to maintain its ratings from all three major rating agencies on our bonds, thus allowing the Trust to continue to provide funds to communities at the lowest cost possible. The Trust's current ratings are:

<u>Ratings on Trust debt</u>	<u>Fitch IBCA</u>	<u>Moody's Investor's Service, Inc.</u>	<u>Standard & Poor's</u>
Pooled Loan Program	AAA	Aaa	AAA
MWRA Loan Program	AA+ – AAA	Aaa	
New Bedford Loan Program	AA – AAA	Aaa (insured) Aa3 (underlying)	
South Essex Sewerage District Loan Program	AA	Aaa	

Financial Highlights – Fiscal 2002

- Assets exceed liabilities by \$1.24 billion, a 7% increase over FY01, at the close of the fiscal year. Included in this number is loans receivable, which increased from \$1.7 billion in FY01 to \$1.8 billion in FY02.
- Net assets increased by \$78.5 million from last year, a net change of 7%.
- Operating income decreased by \$17.0 million from FY01.
- The statement of cash flows indicates a negative change in cash for the year of \$8.6 million.

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- In FY02, the Trust continued to receive its Capitalization Grants from the Environmental Protection Agency in both the Clean Water and Safe Drinking Water programs. The Trust received \$52.3 million for the Clean Water Program and \$5.7 million in the State Drinking Water Program. The Commonwealth provided a match of \$10.5 million for the Clean Water program. This has allowed the Trust to continue to expand the base of capital in the Revolving Fund and support the administrative costs without having to heavily rely on the Commonwealth of Massachusetts to keep the program viable.

Overview of Financial Statements

The financial section of this report consists of the following parts: management's discussion and analysis (this section), the basic financial statements and the notes to the financial statements.

The Trust's financial statements are prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) as applied to government enterprise funds. Under this method of accounting, an economic resources measurement focus and an accrual basis of accounting is used. Revenue is recorded when earned, and expenses are recorded when incurred. The basic financial statements include statements of net assets, statements of revenues, expenses, and changes in net assets, and statements of cash flows. This report also includes footnotes accompanying the statements to fully explain the activities reported in them.

The statements of net assets presents information on the assets and liabilities of the Trust. The difference between the two is net assets. Over time, increases and decreases in net assets may be an indicator of the strength or deterioration of the financial health of the Trust.

The statements of revenues, expenses, and changes in net assets reports the operating revenues and expenses and the nonoperating revenues and expenses of the Trust for the fiscal year. The difference – increase or decrease in net assets – then determines the net change in assets for the fiscal year. This change in net assets added to last year's net assets will reconcile to the total net assets for this fiscal year.

The statements of cash flows reports activity of cash and cash equivalents during the fiscal year resulting from operating activities, capital and related financing activities, noncapital financing activities, and investing activities. The net result of these activities is reconciled to the cash and cash equivalent balances reported at the end of the fiscal year. This statement is prepared using the direct method of presentation which allows the reader to easily discern the amount of cash received from grantors, borrowers and financial institutions and how much cash was disbursed to borrowers, suppliers and bondholders.

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Financial Analysis of the Trust

Net Assets

The Trust's net assets at June 30, 2003 were approximately \$1.3 billion, a 5% increase over the prior year (see Table A-1). Total assets increased 16% to \$3.6 billion, and total liabilities increased 23% to \$2.3 billion.

The Trust's net assets at June 30, 2002 were approximately \$1.2 billion, a 7% increase over the prior year (see Table A-1). Total assets increased 3% to \$3.1 billion, and total liabilities increased 2% to \$1.8 billion.

Table A-1
Massachusetts Water Pollution Abatement Trust's Net Assets
(In thousands)

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>Percentage Change 2003 – 2002</u>	<u>Percentage Change 2002 – 2001</u>
Current assets	\$ 676,854	591,341	589,258	14%	0%
Loans receivable, long term	1,966,473	1,706,689	1,644,786	15%	4%
Other	<u>911,835</u>	<u>777,206</u>	<u>739,418</u>	17%	5%
Total assets	<u>\$ 3,555,162</u>	<u>3,075,236</u>	<u>2,973,462</u>	16%	3%
Current liabilities	\$ 157,806	139,273	140,726	13%	(1)%
Long-term debt	1,983,986	1,663,989	1,611,775	19%	3%
Other	<u>108,568</u>	<u>32,044</u>	<u>59,491</u>	239%	(46)%
Total liabilities	<u>\$ 2,250,360</u>	<u>1,835,306</u>	<u>1,811,992</u>	23%	1%
Net assets:					
Restricted	\$ 1,109,261	1,026,312	903,256	8%	14%
Unrestricted	<u>195,541</u>	<u>213,618</u>	<u>258,214</u>	(8)%	(17)%
Total net assets	<u>\$ 1,304,802</u>	<u>1,239,930</u>	<u>1,161,470</u>	5%	7%

Notwithstanding a declining interest rate environment, the Trust achieved higher interest income than earned in FY02. This was due to successful bids on the Guaranteed Investment Contracts necessary to support the Pool 8 and MWRA transactions and by moving our idle, free cash that is used to make interim loans from the Massachusetts Municipal Depository Trust (MMDT) into more lucrative tax-exempt, short-term instruments that had much higher yields. All of the Trust investment activities are subject to the Treasurer and Receiver General's investing policy.

Long-Term Debt

The Trust incurs long-term debt in order to generate funds for communities for their construction projects under the Clean Water and Drinking Water programs. This debt is offset by the loans receivable carried on the Trust's

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Statements of Net Assets as the debt service requirements of this debt are secured by loan repayments by the borrowers and investment and Commonwealth subsidies.

In FY03, the Trust's long-term debt position increased by \$397 million to \$2.1 billion. This increase is the net change in long-term debt due to the issuance of the Pooled Loan Program, Series 8 issue of \$266.9 million and the MWRA Loan Program, Series 2002A of \$124.8 million which was totally earmarked for new construction funding. The Trust also retired an additional \$73.1 million of outstanding principal through regular payments to bondholders.

Table A-2
Changes in the Massachusetts Water Pollution Abatement Trust's Net Assets
(In thousands)

	<u>June 30, 2003</u>	<u>June 30, 2002</u>	<u>June 30, 2001</u>	<u>Percentage Change 2003 – 2002</u>	<u>Percentage Change 2002 – 2001</u>
Operating revenues:					
Interest income	\$ 124,223	118,210	114,593	5%	3%
Other	<u>3,219</u>	<u>2,918</u>	<u>5,621</u>	10%	(93)%
Total operating revenues	<u>127,442</u>	<u>121,128</u>	<u>120,214</u>	5%	1%
Operating expenses:					
Interest expense	111,194	92,515	83,948	20%	9%
Grant disbursements	25,405	—	—	100%	0%
Program support	19,332	19,795	14,434	(2)%	27%
Other	<u>2,790</u>	<u>7,791</u>	<u>3,780</u>	(64)%	51%
Total operating expenses	<u>158,721</u>	<u>120,101</u>	<u>102,162</u>	32%	15%
Operating income	<u>(31,279)</u>	<u>1,027</u>	<u>18,052</u>	(3,146)%	(1,658)%
Nonoperating (expenses) revenues:					
Operating grants	13,202	9,584	10,522	38%	(10)%
Capitalization grants	82,949	67,849	107,661	22%	(59)%
Other	<u>—</u>	<u>—</u>	<u>(180)</u>	0%	0%
Total nonoperating income	<u>96,151</u>	<u>77,433</u>	<u>118,003</u>	24%	(52)%
Change in net assets	64,872	78,460	136,055	(17)%	(73)%
Total net assets, beginning of year	<u>1,239,930</u>	<u>1,161,470</u>	<u>1,025,415</u>	7%	12%
Total net assets, end of year	<u>\$ 1,304,802</u>	<u>1,239,930</u>	<u>1,161,470</u>	5%	6%

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The increase in operating revenues from 2002 to 2003 by 5% is due primarily to three factors. First, the Trust experienced a 5% increase in interest income, which is primarily the result of the increased cash and investments generated through the issuance of the Pool 8 and MWRA debt and realignment of investments due to market conditions. The second factor was a 10% increase in other income due to a increase in Loan Administration fees as a result of the new fees from the Pool 8 and MWRA issuances being implemented even as some principal balances were being reduced through loan repayments. Third, there was an increase in loan origination fees generated from Interim Loans because the Pool 8 was issued later in the construction season and communities required "bridge" financing to get them through construction as they waited for the Trust to do its next bond issue. Nonoperating revenues decreased by 9% due to the timing of and receipt of EPA capitalization grants and disbursements against those grants.

Operating expenses increased by 32% due to the increase in interest expense which is due to the issuance of the Pool 8 and MWRA bonds and the grants disbursed to local borrowers.

The increase in operating revenues from 2001 to 2002 by 1% is due primarily to three factors. First, the Trust experienced a 3 % increase in interest income, which is primarily the result of the increased cash and investments generated through the issuance of the Pool 7 debt and realignment of investments due to market conditions. The second factor was a 93% decrease in other income due to a decrease in Loan Administration fees as a result of principal balances being reduced while the new fees from the Pool 7 issuance had not yet been implemented. As the Pool 7 debt included funds for refunding, the Trust was not able to assess the borrowers a reimbursement of Cost of Issuance costs. Third, a decrease in loan origination fees generated from Interim Loans because Pool 7 was issued early in the construction season and communities did not require "bridge" financing to get them through construction, waiting for the Trust to do its next bond issue. Nonoperating revenues decreased by 35% due to the timing of and receipt of EPA capitalization grants.

Operating expenses increased by 15% due to the increase in interest expense which is due to the issuance of the Pool 7 bonds. The 27% increase in Program Support was primarily due to the Department of Environmental Protection focusing on finalizing existing contracts with outside vendors, thus processing the final contingency invoices on these contracts.

Loans Receivable

Subsidized financing has been an important incentive for many communities to undertake water and sewer infrastructure improvement projects. Since the enactment of Chapter 95 of the Acts of 1995, which raised the level of loan subsidy on a prospective basis, the Trust has experienced a major increase in of loan activity.

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As the result of state legislation that was enacted early in FY01, the subsidy levels for projects first appearing on an Intended Use Plan (IUP) in calendar year 2002 or later will be reduced. Rather than the current interest rate of approximately 0%, loans for those projects will be made at a rate of 2%. This increase in the interest rate is linked to a decision whereby the Trust will provide additional capacity for loans by leveraging its equity by a 3:1 ratio in the future rather than at the current standard ratio of 2:1. With the change in leveraging ratio, the Trust expects to be able to provide almost 50% more financing for eligible projects. Despite the increase in cost to each borrower, the Commonwealth's projected commitment to provide subsidy funding through contract assistance payments is expected to continue to grow, but at a much slower rate, since the Trust will be able to provide more capital to borrowers due to the change in the leveraging ratio. Even with this effective reduction in the subsidy levels offered to the communities, the program continued to expand, with the Trust's loan receivables increasing \$245.0 million to \$2.07 billion, a net change of 12%.

Future Economic Factors

In August 2002, the Commonwealth enacted Chapter 276 of the Acts of 2002. Sections 4 and 5 of the Act providing for \$46.5 million in matching capitalization funds for the Federal Clean and Drinking Water programs for the fiscal years of 2003 to 2007.

Requests for Information

This financial report is intended to provide an overview of the financial picture of the Massachusetts Water Pollution Abatement Trust for those with an interest in the agency. Any further questions regarding any of the information contained within this report may be directed to the Executive Director or the Treasurer at One Ashburton Place, 12th Floor, Boston, MA 02108.

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Statements of Net Assets

June 30, 2003 and 2002

(In thousands)

	<u>2003</u>	<u>2002</u>
Assets:		
Current assets:		
Cash and cash equivalents (note 3)	\$ 225,511	232,943
Short-term investments (note 3)	182,697	56,297
Grants receivable:		
U.S. Environmental Protection Agency	76,563	99,442
Commonwealth of Massachusetts	18,150	20,650
Loans receivable, current (note 5)	119,861	134,645
Accrued interest receivable	52,807	46,287
Loan servicing fees receivable	1,265	1,077
Total current assets	<u>676,854</u>	<u>591,341</u>
Noncurrent assets:		
Loans receivable, long-term (note 5)	1,966,473	1,706,689
Long-term investments (note 3)	907,298	774,565
Other assets	4,537	2,641
Total assets	<u>3,555,162</u>	<u>3,075,236</u>
Liabilities:		
Current liabilities:		
Accrued expenses	360	332
Accrued interest payable	44,515	38,191
Grants payable (note 7)	9,302	—
Current portion of loan commitments	16,384	27,700
Current portion of long-term debt (note 6)	87,245	73,050
Total current liabilities	<u>157,806</u>	<u>139,273</u>
Noncurrent liabilities:		
Loan commitments	95,837	31,193
Grants payable	11,614	—
Accrued interest on capital appreciation bonds	1,117	851
Long-term debt, net (note 6)	1,983,986	1,663,989
Total liabilities	<u>2,250,360</u>	<u>1,835,306</u>
Net assets:		
Restricted (note 8)	1,109,261	1,026,312
Unrestricted (note 8)	195,541	213,618
Commitments and contingencies (note 9)		
Total net assets	<u>\$ 1,304,802</u>	<u>1,239,930</u>

See accompanying notes to basic financial statements.

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Statements of Revenues, Expenses, and Changes in Net Assets

Years ended June 30, 2003 and 2002

(In thousands)

	<u>2003</u>	<u>2002</u>
Operating revenues:		
Loan servicing fees	\$ 2,837	2,508
Loan origination fees	382	410
Interest income	124,223	118,210
Total operating revenues	<u>127,442</u>	<u>121,128</u>
Operating expenses:		
Commonwealth of Massachusetts:		
Department of Environmental Protection – programmatic support costs	19,332	19,795
General and administrative	2,682	1,674
Arbitrage rebate payments	108	6,117
Grant disbursements	25,405	—
Interest expense	111,194	92,515
Total operating expenses	<u>158,721</u>	<u>120,101</u>
Operating (loss) income	<u>(31,279)</u>	<u>1,027</u>
Nonoperating revenue:		
Operating assistance:		
U.S. Environmental Protection Agency	5,349	1,584
Commonwealth of Massachusetts	7,853	8,000
Capitalization grant revenue (expense):		
U.S. Environmental Protection Agency capitalization grants	73,749	57,963
Commonwealth of Massachusetts matching grants	9,200	9,886
Total nonoperating revenue	<u>96,151</u>	<u>77,433</u>
Increase in net assets	64,872	78,460
Beginning of year net assets	<u>1,239,930</u>	<u>1,161,470</u>
End of year net assets	<u>\$ 1,304,802</u>	<u>1,239,930</u>

See accompanying notes to basic financial statements.

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Statements of Cash Flows
Years ended June 30, 2003 and 2002
(In thousands)

	2003	2002
Cash flows from operating activities:		
Cash received from customers	\$ 3,031	2,909
Cash received from borrowers	134,645	89,871
Interest received	117,703	116,964
Loans and grants disbursed to recipients	(332,703)	(233,157)
Cash paid to suppliers	(20,664)	(27,031)
Interest paid	(104,603)	(90,950)
Net cash used for operating activities	(202,591)	(141,394)
Cash flows from capital and related financing activities:		
Proceeds from USEPA capitalization grants	96,628	49,967
Proceeds from Commonwealth matching capitalization grants	11,700	12,386
Net cash used by capital and related financing activities	108,328	62,353
Cash flows from noncapital financing activities:		
Bonds proceeds	407,788	321,805
Repayment of bonds	(73,050)	(263,090)
Operating assistance from U.S. EPA	5,349	1,584
Operating assistance from Commonwealth of Massachusetts	7,853	8,000
Net cash provided by noncapital financing activities	347,940	68,299
Cash flows from investing activities:		
Purchases of investments	(1,072,209)	(1,536,271)
Proceeds from sales of investments	811,100	1,538,432
Net cash (used) provided by noncapital financing activities	(261,109)	2,161
Net decrease in cash and cash equivalents	(7,432)	(8,581)
Cash and cash equivalents, beginning of year	232,943	241,524
Cash and cash equivalents, end of year	\$ 225,511	232,943
Reconciliation of operating income to net cash used by operating activities:		
Operating income	\$ (31,279)	1,027
Adjustments to reconcile operating income to net cash used for operating activities:		
Amortization	1,428	597
Changes in operating assets and liabilities:		
Loans receivable	(245,000)	(106,677)
Accrued interest receivable	(6,520)	(1,246)
Loan servicing fees receivable	(188)	(9)
Other assets	(1,896)	929
Accrued expenses	28	(42)
Accrued interest payable	6,592	1,565
Deferred revenue	—	(1,515)
Grants payable	20,916	—
Loan commitments	53,328	(36,023)
Net cash used for operating activities	\$ (202,591)	(141,394)

See accompanying notes to basic financial statements.

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(1) Organization

The Massachusetts Water Pollution Abatement Trust (the Trust), a component unit of the Commonwealth of Massachusetts (the Commonwealth), was created by Chapter 275 of the Acts of 1989 of the Commonwealth (the Act) to implement the State Revolving Fund (the SRF) Program for the Commonwealth, contemplated by Title VI of the Federal Clean Water Act (the CWA). The Trust is a state authority and is governed by a board of trustees consisting of the State Treasurer, the Secretary of the Executive Office for Administration and Finance, and the Commissioner of the Department of Environmental Protection (the DEP).

The financial and management activities of the Trust are administered by employees of the State Treasurer's office. The project oversight and direction is provided by the DEP. Certain financial oversight is provided by the Executive Office for Administration and Finance. The Trust commenced operations in June 1990. The long-term goals of the Trust include creating and implementing an SRF program that provides a source of financing for water pollution abatement projects (the projects). Construction of projects on the National Municipal Policy List, the cleanup of Boston Harbor, and the correction of combined sewer overflows (CSO) are prime focuses for the federal SRF Program.

The Trust is authorized by the Act to borrow money through the issuance of revenue bonds and to apply the proceeds thereon, together with federal and state capitalization grants and other funds made available to the Trust, to make loans to local governmental units to finance the costs of eligible water pollution abatement projects (the Leveraged Loan Program).

During fiscal 1993, the legislature enacted an amendment to the Act. This law, Chapter 203 of the Acts of 1992 (Chapter 203), states that all eligible loans made by the Trust can have subsidies that accomplish a grant equivalency of 25%. This amendment further directs that certain projects on the DEP's Intended Use Plan prior to 1992 should receive higher subsidy levels.

Chapter 203 also reduces the total authorization for Commonwealth general obligation bonds for the Trust from \$1.3 billion to \$122 million. State matching funds for the federal SRF and reserve funds for the Commonwealth SRF continue to be funded through a general obligation bond source. However, all subsidy contributions now come from a Commonwealth Contract Assistance Agreement that is provided through the Commonwealth's annual operating budget and cannot exceed \$26 million in any one fiscal year. This has the net effect of reducing authorized Commonwealth debt while still ensuring funding for a perpetual state revolving fund.

During fiscal 1994, the Trust established an Interim Loan Program and a Small Direct Loan Program for local government units' borrowing needs. The Interim Loan Program provides temporary short-term financing to local government units that are to be subsequently refinanced through permanent leveraged loans. The Small Direct Loan Program finances single small projects where leveraged loans would not be financially feasible for the local government units.

During fiscal 1996, the Commonwealth approved an amendment to Chapter 29C of the General Laws to provide a subsidy or other assistance equivalent to a grant of 50% of the eligible costs of the project

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financed by the loan. The amendment is applicable for all loans issued after October 1, 1995. This amendment provides additional subsidy levels of up to \$8 million annually.

Amendments to the federal Safe Drinking Water Act adopted in 1996 provide for the establishment of additional state revolving fund programs to provide financial assistance to various community water systems (including for-profit companies) and not-for-profit noncommunity water systems for expenditures that will facilitate compliance with national drinking water regulations or otherwise advance the health protection objectives of the Safe Drinking Water Act. The Safe Drinking Water Act and draft regulations and other guidance issued by the United States Environmental Protection Agency contemplate that state revolving fund programs established in accordance with the Safe Drinking Water Act will operate under terms and conditions substantially similar to programs developed under the federal Clean Water Act. In addition, the amendments to the Safe Drinking Water Act provide Authority for the consolidation of a Safe Drinking Water Act revolving fund with a Clean Water Act revolving fund for purposes of investment and the issuance of, and security for, bonds.

During fiscal 1998, the Trust created a new fund to account for the receipts and disbursements in conjunction with the Commonwealth's Title V regulations. The Community Septic Management Program Fund is the recipient of amounts bonded for in the Third Pooled Loan Program Financing on April 29, 1997 and the Fourth Pooled Loan Program Financing on December 9, 1998. It also is used for pass-through assistance payments from the Commonwealth to communities to fund administrative costs in setting up loan programs to homeowners at the community level.

The Enabling Act was amended by the Massachusetts legislature on April 2, 1998 to authorize the Trust to establish a revolving fund program under the Safe Drinking Water Act.

In fiscal year 2000, the State legislature passed new legislation which changed the level of subsidies on Trust loans from the 50% grant equivalency level to a flat 2% interest rate to be charged on loans for new projects appearing on the calendar year 2002 intended use plan, going forward. This was in order to mitigate step increases in contract assistance commitments by the Commonwealth while the Trust could increase its leveraging capacity from 2:1 to 3:1 in an effort to get more money to more projects the local level.

(2) Summary of Significant Accounting Policies

The accounting policies of the Trust conform to generally accepted accounting principles as applicable to government enterprises. The following is a summary of the Authority's significant accounting policies:

(a) Basis of Presentation

The Trust's financial statements are prepared using the economic resources measurement focus and the accrual basis of accounting as specified by the Governmental Accounting Standards Board's requirements for an enterprise fund. Operating revenues and expenses are generated through the issuance of loans to local government units within the Commonwealth. All other revenues and expenses are reported as nonoperating revenues and expenses.

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Under Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Trust has elected to apply all Financial Accounting Standards Board Statements and Interpretations issued on or before November 30, 1989, except those that conflict with or contradict GASB pronouncements.

(b) Cash and Cash Equivalents

The Trust's policy is to treat all highly liquid investments with original maturities of three months or less as cash and cash equivalents.

(c) Investments

Investments are carried at fair value. Where applicable, fair values are based upon quotations from national security exchanges.

Under the Massachusetts Water Pollution Abatement Trust Program Resolutions (the Resolutions), as amended and supplemented at various bond sale dates, the Trust must maintain certain investment funds in the Federal SRF Loan Program and Commonwealth SRF Loan Program with State Street Bank & Trust Company (the Trustee). The types of funds held by the Trustee are in the following accounts:

Equity Accounts – The Equity Fund consists of cash and cash equivalents which are currently held at the Massachusetts Municipal Depository Trust (MMDT). The Equity Fund is comprised of both a federal program account and a Commonwealth program account and can be used for programmatic costs and operating expenses within the Federal SRF Loan Program or Commonwealth SRF Loan Program, as applicable. These funds are derived from: (1) funds drawn by the Trust from federal capitalization grants and Commonwealth matching funds; (2) other amounts paid to the Trust representing financial assistance provided pursuant to the Act for purposes of deposit in the Federal SRF Loan Program; (3) other amounts appropriated to the Trust by the Commonwealth for purposes of the Federal SRF Loan Program or Commonwealth SRF Loan Program; (4) direct loan repayment; (5) interest earnings on investment or deposits of amounts held in the Equity Fund; and (6) amounts transferred from the Debt Service Reserve Fund as a result of loan repayments in accordance with the provisions specified in the Resolutions.

Interim Loan Accounts – The Interim Loan Fund has been established to fund temporary loans in anticipation of permanent leveraged borrowings. The source of funds is the Equity Fund.

Project Accounts – The Project Funds disburse bond proceeds to borrowers as needed. These funds are restricted by the bond resolutions and are to be applied solely to the payment or refinancing of costs associated with the applicable project. When all costs have been paid, any amounts remaining unexpended in the Project Funds can be applied to the repayment of the applicable loan service to bondholders. The monies are derived from semiannual loan repayments, which include payments from borrowers, interest earnings on the Debt Service Reserve Funds, and Commonwealth contract assistance payments.

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Debt Service Reserve Accounts – Debt Service Reserve Funds consist of reserve requirements equal to 50% of the principal amount outstanding on Clean Water bonds and 40% on Drinking Water bonds. For bonds issued for finance loans authorized on the current year 2002 intended use plan and moving forward, the debt service reserve fund requirement drops to 33.33% of the outstanding principal. In accordance with each bond resolution, amounts are transferred from the Equity Fund to the particular Debt Service Reserve Funds. Interest earnings on the Debt Service Reserve Funds are transferred to their corresponding Revenue Fund and used for debt service payments.

Debt Service Accounts – Debt Service Funds are used as a pass-through of principal and interest from the Revenue Funds to the bondholders. The Debt Service Funds are also used to hold accrued interest on the bonds to be applied to pay a portion of the interest due on the bonds.

(d) Capital Assets

The Trust's capital asset capitalization policy conforms with the Commonwealth's threshold of \$15,000. As of June 30, 2003 and 2002, the Trust did not have any capital assets.

(e) Loan Origination Fees and Costs of Issuance

Fees received and certain direct costs incurred, relating to the origination of loans, have been deferred and are included with loans receivable in the accompanying balance sheets. Loan origination fees and costs are amortized over the life of the loans to which the fees and costs relate using the level-yield method. Origination fees charged to leveraged borrowers are capped at the estimated costs of leveraged transactions as proposed in the Trust's administrative budget and allocated to all borrowers, excluding the Title V program.

(f) Risk Financing

The Trust is not insured for casualty, theft, tort claims, or other losses. No amounts have been accrued for such losses as they are not considered material. As discussed in note 1, all financial, management and project oversight activities are provided by employees of the State Treasurer's Office, DEP, and the Executive Office for Administration and Finance. These employees are covered under the Commonwealth's workers' compensation and group insurance programs. The cost of these programs is allocated to the Trust, through the fringe benefit allocation. As described in note 4, the Trust is only allowed to expend up to 4% of the federal capitalization grant on program administration costs; therefore, any costs in excess of this amount will be borne by the Commonwealth. As a result, no liability for workers' compensation or group insurance has been recorded by the Trust.

(g) Capitalization Grants

Funding from federal capitalization grants and state matching grants are recorded as nonoperating revenues.

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(h) Other Assets

Other assets consist of the unamortized portion of bond issue costs, which are amortized using the straight-line method over the life of the bonds, and deferred charges, which are “unreclassified” state appropriations for matching funds that are allocated to administrative costs.

(i) Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, at the date of the financial statements and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.

(3) Deposits and Investments

Cash, cash equivalents, and investments are separately held by several of the Trust’s funds.

(a) Cash and Cash Equivalents

The Trust’s cash and cash equivalents, \$225,511 and \$232,943, as of June 30, 2003 and 2002, respectively, represent units purchased in the Massachusetts Municipal Depository Trust (MMDT). The Treasurer of the Commonwealth of Massachusetts oversees the financial management of the MMDT, a local investment pool for cities, towns and other state and local agencies within the Commonwealth. The Trust’s fair value of its investment in the MMDT represents their value of the pool’s share. For purposes of risk organization, MMDT shares are not categorized.

(b) Investments

Trust management invests primarily in U.S. government securities and guaranteed investment contracts.

The Trust’s investments are categorized below, indicating the level of risk assumed by the Trust at year-end. Category 1 includes investments insured or registered in the Trust’s name or securities held by the Trust or its agent (State Street Bank and Trust Company) in the Trust’s name. Category 2 includes investments uninsured and unregistered with securities held by the broker’s or dealer’s trust department or agent in the Trust’s name. Category 3 includes investments uninsured and unregistered with securities held by the broker or dealer, or by its trust department or agent, but not in the Trust’s name.

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(In thousands)				Total fair value
June 30, 2003				
Category				
1	2	3		
Uncategorized guaranteed investment contracts:				
Long term	\$ 907,298	—	—	907,298
Short term	182,697	—	—	182,697
	<u>\$ 1,089,995</u>	<u>—</u>	<u>—</u>	<u>1,089,995</u>

(In thousands)				
June 30, 2002				
	Category			Total fair value
	1	2	3	
U.S. Treasury Bonds	\$ 6,281	—	—	6,281
Uncategorized guaranteed investment contracts:				
Long term	768,284	—	—	768,284
Short term	56,297	—	—	56,297
	\$ 830,862	—	—	830,862

(4) Capitalization Grants

The operating agreements for the federal capitalization grants require that the Trust enter into binding commitments with local government units within one year of the receipt of each federal grant payment to provide assistance in an amount equal to 120% (including 20% state matching grants) of each federal capitalization grant. Federal grant payments are received by the Trust in the form of an automated clearing house account. For financial statement purposes, federal capitalization grants and the 20% state matching grants has been recognized in the Federally Capitalized SRF for the amount of executed loan agreements and binding commitments.

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The Federal Safe Drinking Water Program and the Federally Capitalized Community Hardship Loan Program have different allocation percentages. For the Federal Safe Drinking Water Program, each grant year has a different allocation based on the amount of federal set-asides used. An additional 20%, or \$5.7 million was matched from required state matching funds, already on hand at the Trust. All draws for project costs and for reserve funding must maintain this proportionality under the Federal Safe Drinking Water Act. For the 2003 and 2002 grant years, the proportionality is determined as follows:

Clean water program	Grant year	
	2003	2002
Federal capitalization	\$ 44,968,770	52,262,998
State match on federal funds (20%)	9,052,599	10,452,599
Total capitalization	54,021,369	62,715,597
Less federally mandated "set-asides"	(1,810,520)	(2,090,520)
Project capitalization	\$ 52,210,849	60,625,077
Federal proportionality	80%	80%
State proportionality	20%	20%

Drinking water program	Grant year	
	2003	2002
Federal capitalization	\$ 28,780,400	5,700,000
State match on federal funds (20%)	5,757,580	—
Total capitalization	34,537,980	5,700,000
Less federally mandated "set-asides"	(5,634,864)	(5,700,000)
Project capitalization	\$ 28,903,116	—
Federal proportionality	80%	0%
State proportionality	20%	0%

The Federally Capitalized Community Hardship Loan Program has an 85% federal funding portion. The remaining 15% is funded from services provided "in-kind" by the DEP to either the EPA or to the borrower. This loan program was completed in fiscal year 2003 with the final disbursement to Hinsdale to complete their clean water project.

The Clean Water State Revolving Fund Loan Program is unchanged from previous years. The total federal award and the state matching funds of 20% are reduced by 4% for an administrative allowance. The total amount available for financing is net of this allowance.

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(5) Loans Receivable and Bonds Purchased

The Trust issued a total of eighty-nine loan or bond purchase agreements during fiscal 2003. An additional thirty-three loans were disbursements under the Community Septic Management Program Fund. Pursuant to agreements with the EPA, bond purchase agreements are used for communities involved in extended financing. Of the eighty-nine agreements, seven were issued as 30-year bond purchase agreements to the towns of Kingston and West Boylston, as well as the Massachusetts Development Finance Authority for a total of \$40.3 million.

A summary of these receivables as of June 30, 2003 and 2002 is as follows (amounts in thousands):

	<u>2003</u>	<u>2002</u>
Leveraged loans or bonds purchased	\$ 2,053,050	1,744,192
Direct loans	22	1,121
Interim loans	<u>33,262</u>	<u>96,021</u>
	2,086,334	1,841,334
Current portion	<u>119,861</u>	<u>134,645</u>
Long-term portion	<u><u>\$ 1,966,473</u></u>	<u><u>1,706,689</u></u>

Aggregate principal maturities on loans receivable or bonds purchased are as follows (amounts in thousands):

2004	\$ 119,861
2005	88,945
2006	90,110
2007	92,680
2008	94,840
Thereafter	<u>1,599,898</u>
	<u><u>\$ 2,086,334</u></u>

Subsidy payments to be applied to repayments from borrowers include interest earnings provided by Debt Service Reserve Funds and contract assistance provided to the Trust by the Commonwealth. Both of these subsidies are expected to be available for the lives of the financing agreements. For the leveraged bond purchase program, pursuant to an agreement with the Commonwealth, subsidies are drawn in an amount as if the financing was for a twenty-year period. The amount that is not currently needed is invested at the applicable bond yield until funds are needed for subsidies beyond year 20, similar to an annuity. If subsidy funds are not available, the obligation of the borrower is increased by such shortfall.

The agreement requires the borrower to pay the Trust an annual or semiannual servicing fee equal to 0.15% or 0.075%, respectively, of the principal obligation outstanding on the applicable date. As of

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June 30, 2003, all borrowers have opted for the semiannual payment schedule. None of these fees are capitalized as part of a borrower's obligation to the Trust.

(6) Bonds Payable

The following is a summary of bonds payable at June 30, 2002 and 2003 (in thousands):

	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Due within one year</u>
Water Pollution Abatement					
Revenue Bonds:					
MWRA Loan Program:					
Series 1993A, 4.5% to 5.45%, issued March 18, 1993, due 2000 to 2013	\$ 10,610	—	1,420	9,190	1,350
Series 1993B, 4.3% to 5.25%, issued January '6, 1994, due 2000 to 2014	7,915	—	855	7,060	830
Series 1995A, 4.5% to 6.0%, issued November 21, 1995, due 2000 to 2015	9,260	—	905	8,355	895
Series 1998A, 4.0% to 5.375%, issued July 9, 1998, due 2000 to 2018	17,030	—	1,375	15,655	1,355
Series 2002A, 3.0% to 5.25%, issued October 15, 2002, due 2003 to 2032	—	124,800	—	124,800	3,105
South Essex Sewage District					
Loan Program:					
Series 1994A, 5.3% to 6.375%, issued November 1, 1994, due 2001 to 2015	10,800	—	1,185	9,615	1,155
Series 1996A, 4.25% to 6.0%, issued December 5, 1996, due 2000 to 2016	11,645	—	1,130	10,515	1,095
New Bedford Loan Program:					
Series 1996A, 4.8% to 6.0%, issued July 10, 1996, due 2000 to 2016	17,265	—	1,815	15,450	1,760
Pool Loan Program:					
Series 1, 4.75% to 5.6%, issued July 14, 1993, due 2000 to 2013	38,810	—	5,015	33,795	4,450

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	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Due within one year</u>
Pool Loan Program (continued):					
Series 2, 4.9% to 6.125%, issued June 1, 1995, due 2001 to 2015	\$ 19,440	—	3,095	16,345	3,250
Series 3, 4.6% to 6.0%, issued April 29, 1997, due 2001 to 2017	54,225	—	6,815	47,410	6,970
Series 4, 4.0% to 5.125%, issued December 9, 1998, due 2000 to 2018	136,625	—	7,220	129,405	7,355
Series 5, 4.25% to 5.75%, issued October 6, 1999, due 2000 to 2029	252,180	—	10,675	241,505	10,870
Series 6, 4.5% to 5.66% issued November 6, 2000, due 2001 to 2030	329,570	—	12,575	316,995	13,265
Series 7, 3.0% to 5.25% issued July 15, 2001, due 2001 to 2021	318,780	—	8,945	309,835	9,905
Series 8, 3.0% to 5.0% issued November 15, 2002, due 2003 to 2032	—	266,885	—	266,885	9,085
Subordinated Revenue					
Refunding Bonds:					
New Bedford Loan Program:					
Series 1998A, 4.0% to 5.25%, issued December 23, 1998, due 2001 to 2026	117,935	—	2,260	115,675	2,415
MWRA Loan Program:					
Series 1999A, 4.2% to 6.0%, issued November 3, 1999, due 2000 to 2029	384,335	—	7,765	376,570	8,135
Subtotal	1,736,425	391,685	73,050	2,055,060	87,245
Less unamortized amounts:					
Bond premium	9,708	16,103	1,955	23,856	—
Net unamortized excess of reacquisition price over net carrying value of defeased bonds	(9,476)	—	(1,791)	(7,685)	—
Total bonds payable	\$ 1,736,657	407,788	73,214	2,071,231	87,245

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The following is a summary of bonds payable at June 30, 2001 and 2002 (in thousands):

	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Due within one year</u>
Water Pollution Abatement					
Revenue Bonds:					
MWRA Loan Program:					
Series 1993A, 4.5% to 5.45%, issued March 18, 1993, due 2000 to 2013	\$ 12,095	—	1,485	10,610	1,420
Series 1993B, 4.3% to 5.25%, issued January '6, 1994, due 2000 to 2014	8,790	—	875	7,915	855
Series 1995A, 4.5% to 6.0%, issued November 21, 1995, due 2000 to 2015	10,185	—	925	9,260	905
Series 1998A, 4.0% to 5.375%, issued July 9, 1998, due 2000 to 2018	18,425	—	1,395	17,030	1,375
South Essex Sewage District Loan Program:					
Series 1994A, 5.3% to 6.375%, issued November 1, 1994, due 2001 to 2015	62,840	—	52,040	10,800	1,185
Series 1996A, 4.25% to 6.0%, issued December 5, 1996, due 2000 to 2016	71,390	—	59,745	11,645	1,130
New Bedford Loan Program:					
Series 1996A, 4.8% to 6.0%, issued July 10, 1996, due 2000 to 2016	19,140	—	1,875	17,265	1,815
Pool Loan Program:					
Series 1, 4.75% to 5.6%, issued July 14, 1993, due 2000 to 2013	60,320	—	21,510	38,810	5,015
Series 2, 4.9% to 6.125%, issued June 1, 1995, due 2001 to 2015	43,105	—	23,665	19,440	3,095
Series 3, 4.6% to 6.0%, issued April 29, 1997, due 2001 to 2017	112,585	—	58,360	54,225	6,815
Series 4, 4.0% to 5.125%, issued December 9, 1998, due 2000 to 2018	143,720	—	7,095	136,625	7,220

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	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Due within one year</u>
Pool Loan Program (continued):					
Series 5, 4.25% to 5.75%, issued October 6, 1999, due 2000 to 2029	\$ 262,040	—	9,860	252,180	10,675
Series 6, 4.5% to 5.66% issued November 6, 2000, due 2001 to 2030	341,430	—	11,860	329,570	12,875
Series 7, 3.0% to 5.25% issued July 15, 2001, due 2002 to 2021	—	321,805	3,025	318,780	8,945
Subordinated Revenue					
Refunding Bonds:					
New Bedford Loan Program:					
Series 1998A, 4.0% to 5.25%, issued December 23, 1998, due 2001 to 2026	120,045	—	2,110	117,935	2,260
MWRA Loan Program:					
Series 1999A, 4.2% to 6.0%, issued November 3, 1999, due 2000 to 2029	391,600	—	7,265	384,335	7,765
Subtotal	1,677,710	321,805	263,090	1,736,425	73,350
Less unamortized amounts:					
Bond premium	—	9,302	(406)	9,708	—
Net unamortized excess of reacquisition price over net carrying value of defeased bonds	—	(8,879)	597	(9,476)	—
Total bonds payable	\$ 1,677,710	322,228	263,281	1,736,657	73,350

All bonds are payable from amounts pledged pursuant to the Water Pollution Abatement Project Bond Resolutions, which include payments by the local governmental units of principal and interest on the loans and amounts on deposit in the Debt Service Reserve Funds. Pursuant to the Commonwealth Assistance Contract (the Contract), the Commonwealth has agreed to provide Contract Assistance payments to the Trust to reduce the payments by local governmental units. The Contract is not pledged as security for the bonds; however, the Contract Assistance payments, when received by the Trust, are pledged as security for the bonds.

In October 2002, the Trust issued \$124.8 million of MWRA Program Bonds, Series 2002A. This was issued to finance projects of the MWRA's capital improvement program to upgrade waste water treatment facilities to eliminate pollution from unlawful sewage discharges as part of a federal court-ordered environmental protection program for Boston Harbor and to improve its drinking water treatment and distribution system.

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In November 2002, the Trust issued \$266.9 million of Pool Loan Program, Series 8. This was issued to fund under water pollution abatement projects and drinking water projects under Federal Programs across the 74 communities and special districts.

In July 2001, the Trust issued \$321.8 million of Water Pollution Abatement Revenue Bonds Pool Loan Program Series 7. This issue included \$198.3 million of refunding bonds and \$123.5 million of funds for new Clean Water and Drinking Water program projects. The proceeds of the refunded debt were deposited into a refunding trust escrow to defease \$195.9 million of previously issued debt. The advance refunding resulted in a difference between the reacquisition price and the carrying amount of the defeased Bonds and a decrease in the corresponding Pool loans and the South Essex Sewerage District (SESD) loans of \$8.9 million and resulted in an economic gain of \$6.5 million. This difference decreased the outstanding bonds of the Trust and the corresponding loans receivable from the SESD and the various borrowers included in Pools 1, 2 and 3.

Scheduled future debt service payments are as follows (amounts in thousands):

	Total debt service	Principal	Interest
Year ending June 30:			
2004	\$ 191,560	87,245	104,315
2005	189,464	88,945	100,519
2006	186,660	90,110	96,550
2007	188,763	92,680	96,083
2008-2012	182,558	94,840	87,718
2013-2017	866,446	499,405	367,041
2018-2022	719,835	487,700	232,135
2023-2027	474,022	359,780	114,242
2028-2031	216,070	172,850	43,220
2029-2033	89,260	81,505	7,755
	<u>\$ 3,304,638</u>	<u>2,055,060</u>	<u>1,249,578</u>

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At June 30, 2003, the outstanding balances of bonds defeased “in-substance” in prior years is as follows (amounts in thousands):

Description	Redemption date	Outstanding principal amount	
		2003	2002
MWRA Loan Program:			
Series 1993A	November 3, 1999	\$ 79,485	82,360
Series 1993B	November 3, 1999	52,250	54,930
Series 1995A	November 3, 1999	55,410	57,760
Series 1998A	November 3, 1999	92,720	95,620
New Bedford Loan Program:			
Series 1996A	December 23, 1998	94,100	99,060
South Essex Sewage District Loan Program:			
Series 1994A	July 15, 2001	47,095	50,830
Series 1996A	July 15, 2001	53,570	56,125
Pool Loan Program:			
Pool 1	July 15, 2001	16,530	16,530
Pool 2	July 15, 2001	20,720	20,720
Pool 3	July 15, 2001	51,695	51,695

(7) Grants Payable

Grants payable of \$20,916 represent amounts related to bond premiums received in connection with bond issuances that will be distributed to pool borrowers to assist them in their completion of their water pollution abatement or drinking water projects.

(8) Net Assets

As of June 30, 2003, the Trust has restricted net assets in the amount of \$1,109,261 and unrestricted net assets in the amount of \$195,541. Restricted net assets represent capitalization grants received cumulative to date from the U.S. Environmental Protection Agency and corresponding matching amounts received from the Commonwealth of Massachusetts. The capitalization grants are restricted to provide financial assistance, but not grants, to local communities and interstate agencies for the construction of wastewater treatment works, drinking water infrastructure improvements, and other related projects as described in note 1.

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(9) Commitments

As of June 30, 2003, the Trust has agreed to provide loans to various local government units amounting to approximately \$33 million, excluding loans to be disbursed, which will be funded or collateralized with grant awards received through June 30, 2003.

(10) Subsequent Events

On October 10, 2003, the Trust issued \$311.9 million of Massachusetts Water Pollution Abatement Trust, Pool Program Bonds, Series 9. The bonds were issued to fund water pollution abatement projects and drinking water projects under their federal programs.